No. 80

IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

MARK E. SCHLUDE and MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

ON [redacted] WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF AMICUS CURIAE OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

DEAN ACHESON
FONTAINE C. BRADLEY
JOHN T. SAPIENZA
701 Union Trust Building
Washington 5, D. C.
Attorneys for Amicus Curiae American Institute of Certified Public Accountants

ROBERT L. RANDALL
ALVIN FRIEDMAN
COVINGTON & BURLING
Of Counsel

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STATEMENT OF INTEREST OF THE INSTITUTE

The American Institute of Certified Public Accountants is a nation-wide professional organization of more than 42,500 certified public accountants out of a total of approximately 70,000 in the United States. It is a non-profit organization chartered under the laws of the District of Columbia, and is the only national professional organization of certified public accountants. Its membership embraces certified public accountants from every state and territory, and from the District of Columbia and Puerto Rico.

The Institute and its members have a profound interest in maintaining a proper relationship between accepted accounting principles and accounting for tax purposes. They believe the decision of the Court of Appeals for the Eighth Circuit in *Schlude v. Commissioner* has erroneously construed and applied this Court's decision in *American Automobile Association v. United States*, 367 U.S. 687, in a manner that will have a far-reaching and adverse impact upon many taxpayers who report income on the accrual basis. Reversal of the decision below, the Institute believes, is required to assure the proper administration of the federal income tax laws and to avoid unnecessary confusion, uncertainty and litigation that may otherwise develop in the field of tax accounting by accrual basis taxpayers. The Institute, accordingly, submits this brief *amicus curiae* in support of the position of the taxpayers in the *Schlude* case and urges that the decision of the Court of Appeals be reversed for the reasons set forth below.

The consent of the parties to the filing of this brief *amicus curiae* has been filed with the Clerk of the Court.

OPINIONS BELOW, JURISDICTION AND STATUTES INVOLVED

The Institute respectfully refers the Court to the brief of the taxpayers for the statement of the Opinions Below, Jurisdiction and Statutes Involved.

QUESTION PRESENTED

The question presented is: When an accrual basis taxpayer's method of accounting accurately matches revenues derived from services performed in the tax year with related costs, does the decision in *American Automobile Association v. United States*, 367 U.S.

687, authorize the Commissioner to tax as income the entire face amount of long-term executory service contracts in the year such contracts are signed even though a large portion of amounts received under the contracts in that year has not yet been earned and another large portion of the face amount of the contracts has been neither received nor earned?

STATEMENT

Petitioners operated a partnership that provided dance instruction services. The students taking instruction paid a portion of the face amount of contracts entered into with the partnership when the contracts were signed and promised to pay the remainder thereafter in installments (R. 146-149, 160, 249-250).[1] The contracts giving rise to the income here in question ordinarily ran for a period greater than a single tax year (R. 184, 250). Although the contracts bound the partnership to perform the required services, the dates for each hour of instruction were not scheduled in the contracts but were agreed to from time to time with the student as individual lessons were given (R. 227, 249-250). Each contract, however, provided a period certain before the expiration of which all the hours of instruction contracted for were required to be taken.

[1] Under some contracts a student made all subsequent payments directly to the partnership. Under another type of contract the student made a part of the subsequent payments to the partnership and another part, evidenced by the student's negotiable note, to a bank to which the partnership had transferred the note. Upon such transfer, the bank deducted interest charges, paid approximately 50 percent of the balance of the note to the partnership and retained the remainder in a reserve account which the partnership could not draw upon until the student had paid the note in full (R. 146-149, 160-161, 250-251). ("R.—" references are to the printed record in this Court.)

and was reported as income on the accrual basis in the partnership's tax return for that year (R. 185-188, 251-256).[2]

Contending that the entire face amount of each contract constituted income to the partnership in the year in which the contract was signed, the Commissioner rejected the partnership's accounting system for tax purposes and instead increased the net income of the partnership for each of the tax years 1952, 1953 and 1954 by some $24,000, $105,000 and $13,000—the total increase in the "deferred income" account for each such year (R. 256-258). On this basis, he determined deficiencies against the taxpayers for these years of some $16,000, $82,000 and $11,500, respectively (R. 247). The Tax Court, three judges dissenting, sustained the Commissioner's ruling. It held that the entire face amount of each contract was income in the year in which it was signed, although in that year a large portion of amounts collected from the student was as yet unearned by performance and another large portion of the face amount of the contract remained both uncollected and unearned (R. 246, 258).

The Court of Appeals for the Eighth Circuit reversed and held that the accrual accounting system used by the partnership was "eminently designed to reflect true income" (R. 288). This Court thereafter granted a Writ of Certiorari on the Petition of the Commissioner, vacated the judgment of the Court of Appeals and remanded the case to that court "for further consideration in light of ***American Automobile Association* v. *United States*, [367 U.S. 687]**." See 367

[2] Any gain arising from the cancellation of a contract by a student or by the partnership (where no instruction had been given for a year) was also reported as income on the tax return (R. 192, 253).

U.S. 911 and 368 U.S. 873. On remand the Court of Appeals rendered a *per curiam* opinion in which it affirmed the decision of the Tax Court (R. 273). Citing nothing more than the *American Automobile* decision, the court stated: "In light of that case we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes, clearly reflect income" (R. 274). On May 28, 1961, this Court issued a Writ of Certiorari on the Petition of the taxpayers (R. 276).

SUMMARY OF POSITION OF THE INSTITUTE

I

American Automobile Association v. United States, 367 U.S. 687, does not bar taxpayers from using the accrual method of accounting for advance receipts whereby the reporting of such amounts as income may be postponed to a later tax year if, by such postponement, such method accurately and precisely matches revenues from services performed in each tax year with related costs of performance. That decision held only that the Commissioner of Internal Revenue is empowered to disregard such method if it does not precisely and accurately match the taxpayer's cost of performing services for individual customers with revenues derived from each such customer.

The discussion by the majority of the Court in *American Automobile* of the enactment and repeal of Sections 452 and 462 of the Internal Revenue Code of 1954 does not support any broader reading of that decision to bar the use for tax purposes of any method

of accrual accounting for advance receipts, no matter how accurate and precise, because it may involve reporting such receipts as income in a subsequent tax year. The Court's consideration of these Code sections had application only to the particular accrual accounting method presented in *American Automobile*, in which the taxpayer used over-all estimates and averages of costs to determine when the advance receipts there involved were reportable as income. Moreover, to read into this portion of *American Automobile* any broad rejection of accrual accounting for advance receipts would disregard legislative and administrative developments that have occurred subsequent to the decision in that case.

Any such broad interpretation would, in addition, conflict with fundamental principles governing accrual accounting for tax purposes that the Court has developed over the years commencing with *United States v. Anderson*, 269 U.S. 422. That case and the subsequent consistent precedents of the Court in this field establish that: 1) as to the reporting of receipts as income, "all events" must have occurred that fix an accrual basis taxpayer's right to funds that may previously have been paid to him—or that may still be due; and 2) as to taking deductions, "all events" must have occurred that fix such a taxpayer's obligation with regard to an expense that may previously have been paid by him—or that he may be required to pay. *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290; *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182; *Security Flour Mills v. Commissioner*, 321 U.S. 281; *Lewyt Corp. v. Commissioner*, 349 U.S. 237; *Consolidated Edison Co. v. United States*, 366 U.S. 380.

These decisions supply no warrant for selecting any year in which to tax receipts of an accrual basis taxpayer other than the year in which the receipts—whether received or to be received—are earned by the taxpayer's performance. This rule is in full accord with the relevant provisions of the Internal Revenue Code and the Treasury Regulations that govern accounting for income tax purposes. It is further supported by the adverse practical consequences that would result from requiring accrual basis taxpayers to report receipts as income no later than the year of receipt.

II

The accrual accounting method for advance receipts used by the taxpayers in *Schlude* fully satisfied the standards set forth in *American Automobile* with regard to matching receipts with the costs of performance. Income was reported in each tax year precisely to the extent it was earned by the taxpayers in fulfilling contracts with students that year. It is not significant in appraising the taxpayers' method of accrual accounting for tax purposes that the contracts did not definitely schedule the performance of services by the taxpayers in years subsequent to the year in which a contract was entered into. This uncertainty as to the taxpayers' performance could not affect their reporting of all receipts as income. Under the taxpayers' accounting practice, all income from each contract was reported not later than the year in which the contract expired, which was fixed in every case, or earlier if the student cancelled the contract or took no instruction for one year.

III

The error below is highlighted by the ruling that the *Schlude* taxpayers must report as income in the year of execution portions of the face amount of the service contracts that were neither received nor earned by the taxpayers. Nothing in *American Automobile* supports such a result. Nor does *Commissioner* v. *Hansen*, 360 U.S. 446, where the accrual basis taxpayers—unlike the taxpayers in *Schlude*—had fully performed their obligations under contracts with customers and had accordingly earned all of the contract price.

The method of accrual accounting as used in *Schlude* was as accurate in fixing the year for taxing uncollected portions of the service contracts as it was in fixing the year for taxing advance receipts. For this reason the improper extension of *American Automobile* to amounts not yet collected would be remedied if the Court held the *Schlude* taxpayers' accounting method proper for tax purposes.

POSITION OF THE INSTITUTE

The *Schlude* case presents the Court with a needed opportunity to clarify the principles that govern accrual accounting for advance receipts in federal income tax law. This opportunity, the Institute respectfully submits, is most timely. The Court's decision in *American Automobile Association* v. *United States*, 367 U.S. 687, although reviewing and restating the applicable law, left unanswered substantial questions that *Schlude* squarely presents. Without resolution of these questions by the Court, it appears likely that controversy in this area between the Commissioner of Internal Revenue and accrual basis taxpayers will persist. *Cf. Automobile Club of New York* v. *Commis-*

sioner, 304 F.2d 781 (2d Cir. 1962), *aff'g*, 32 T.C. 906 (1959);[3] *Beverley J. Sandegren*, 21 T.C.M. No. 16, Dkt. No. 76622 (1962) (on appeal to the Court of Appeals for the Ninth Circuit); *Smith Motors, Inc.* v. *United States*, 61-2 U.S.T.C. ¶ 9627 (D. Va. 1961).[4]

From the viewpoint of this *amicus*, the key issue is whether *American Automobile* may properly be construed, as the court below apparently did, to foreclose the use for income tax purposes of accrual accounting for advance receipts because it may postpone reporting of income to a subsequent tax year, notwithstanding that, by such postponement, there is an accurate and precise matching of revenues from services performed in each tax year with related costs of performance. If, as we urge, the Court cannot have intended such a sweeping rule, *Schlude*, of course, presents for decision the question of the validity for tax accounting purposes of the accrual accounting method used by the taxpayers there. Finally, the case requires resolution of a narrower issue which, the Institute considers, is encompassed by the preceding questions. It is whether the face amount of an execu-

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[3] In *Automobile Club of New York*, *supra*, two judges of the Court of Appeals for the Second Circuit indicated their view that this Court's decision in *American Automobile* had not shaken the authority of Bressner Radio, Inc. v. Commissioner, 267 F. 2d 520 (2d Cir. 1959), which permitted advance receipts on television repair contracts to be reported as income in the year repair services were rendered. However, the third member of the panel in *Automobile Club of New York*, although concurring, expressed the view that *Bressner* had been rejected by the *American Automobile* decision.

[4] See Krahmer, J.R., Taxation of Prepaid Receipts, 47 A.B.A.J. 1218, 1220 (1961); Note, Accrual Method of Accounting for Federal Tax Purposes: A Need for Stability in an Area of Confusion, 48 Va. L. Rev. 731, 742-743 (1962).

tory contract—in *Schlude*, for the performance of services—may be taxed as income to an accrual basis taxpayer in the year in which the contract is signed although a large part of the contract price will be neither received nor earned by the taxpayer until a subsequent tax year.

I. Accrual basis taxpayers may report income for tax purposes by use of accrual accounting procedures for advance receipts that accurately and precisely match revenues from services performed in each taxable year with related costs of performance.

From a commercial and accounting point of view a business man using the accrual method of accounting is not regarded as having income upon merely entering into a contract to perform services or to deliver goods in subsequent years or upon the mere receipt of funds under such a contract. He is regarded as having income only when he has earned it by having performed the services or delivered the goods.[5] On the same basis, it has long been recognized in the income tax laws that receipts should be taxed as income in the tax year in which they are earned, since in this way there is offset against the amount earned the cost of earning it. On the many occasions on which this Court has examined this business and accounting principle it has never rejected its validity, though it has, on occasion, held that particular methods of applying it did not achieve its basic purpose—to bring into the same

[5] See Kohler, E., *Auditing*, p. 432 (1954); Mason, Davidson and Schindler, *Fundamentals of Accounting*, p. 271 (3d ed. 1959); Moonitz and Staehling, *Accounting: An Analysis of Its Problems*, vol. I, p. 309 (1952); Paton and Paton, *Corporate Accounts and Statements*, p. 282 (1955); see also authorities cited at p. 33 below.

tax year the amounts actually earned and the actual costs of earning them.

The *American Automobile Association* case was such a decision. That decision did not reject the use of the accrual principle, as such, for the reporting of advance receipts as income in the year in which they were earned. It did reject the application of the principle by the taxpayer in that case because of defects in bringing together specific receipts and the costs of earning them, which defects are not in any way present in the case now before the Court. Those who argue for a more sweeping interpretation of the *American Automobile Association* case would put it in direct conflict with decisions of the Court that recognize as proper for tax purposes the reporting of income as it is "earned" by an accrual basis taxpayer and with relevant sections of the Internal Revenue Code and regulations thereunder governing tax accounting. And such an interpretation would perpetuate an unwarranted distinction between established principles of commercial accounting and accounting for tax purposes, and seriously distort the reporting of income by many accrual basis taxpayers whose accounting procedures for advance receipts are accurate and precise.

A. AMERICAN AUTOMOBILE DOES NOT BAR PRECISE AND ACCURATE ACCRUAL ACCOUNTING OF ADVANCE RECEIPTS FOR TAX PURPOSES

1. *American Automobile* required the Court to rule only whether the Commissioner of Internal Revenue was empowered to disregard the method of accrual accounting for advance receipts used by a taxpayer, a national membership automobile club, which method did not precisely match the portion of the cost of performing services for its individual members in the tax

year with the proper portion of dues revenues prepaid by each member for a twelve-month membership period. Because the number of individual members was large, the taxpayer sought to rely upon its over-all experience in performing services for all of its members in order to determine the cost of service performed for any one member. Its accrual accounting procedures required only that dues be reported as income for tax purposes on a month-by-month basis ratably over the membership period, without regard to the actual cost of services rendered to each member but keyed at best to a statistically calculated cost deemed sufficiently representative of actual cost. 367 U.S. at pp. 688, 690. For this reason the Court considered the *American Automobile* case controlled in essential respects by *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 189, which upheld the Commissioner's rejection for income tax purposes of substantially the same accrual accounting system because recording the accrual of the membership dues paid to the taxpayer "in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the members."

From a tax accounting point of view, therefore, both the *Michigan* and *American Automobile* cases turn on the fact that in recording the accrual of income for tax purposes in any year neither taxpayer could validly demonstrate that there had been precise matching of the portions of the membership dues with the related expenses of rendering services to individual members. This was deemed crucial by the Court in *American Automobile*. Thus, the Court characterized the accrual accounting system there used as one which caused earned income to be reported over the membership

period "without regard to correspondingly fixed individual expense or performance justification" and which was not related to "the actual incidence of cost in serving an individual member" (but was rather on a "group or pool basis") or "in fact related to the expenses incurred." 367 U.S. at pp. 692-693.[6]

The extensive consideration of the adequacy of the taxpayer's accounting practices strongly indicates that the Court's holding in *American Automobile* was only that it was not unsound for the Commissioner to reject that particular method of accrual accounting for advance receipts. From an accounting point of view the Institute earnestly urges that in the present case the Court make clear that its decision in *American Automobile* was confined solely to that issue.

2. The actual holding of the majority of the Court was stated clearly and succinctly by Mr. Justice Clark (367 U.S. at p. 693):

> "... [T]he federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit."

Respondent, however, seeks to support a far broader reading of *American Automobile* and points to the discussion that appears in the opinion of the action of

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[6] In Milwaukee & Suburban Transport Co. v. Commissioner, 292 F.2d 629 (7 Cir. 1961), *cert. denied*, 368 U.S. 976, there was a comparable reliance by the taxpayer upon over-all averages in recording the accrual of deductions for future expenses representing claims lodged against it. This was one basis upon which the Commissioner contended that the *American Automobile* decision sustained his rejection of the taxpayer's method of accrual accounting. See pp. 4-5 of the Memorandum for the Respondent in Opposition to the Petition for Certiorari of the taxpayer in the Milwaukee case, No. 603, October Term, 1961.

Congress in enacting in 1954, and repealing a year later, Sections 452 and 462 of the Internal Revenue Code of 1954. This portion of the Court's opinion, respondent has asserted, recognizes in the Commissioner the discretionary power to bar the use for tax purposes of any method of accrual accounting for advance receipts no matter how accurate and precise, if it may involve reporting such receipts as income in a subsequent tax year.[7]

But Justice Clark made explicit, as we have noted above, that the majority's concern was with a method of accrual accounting that is dependent, in relating costs and revenues, upon "average experience" with expenses incurred by the taxpayer in rendering performance. Accordingly, the consideration in *American Automobile* of the legislative history of the two 1954 Code provisions, which dealt specifically with advance receipts and reserves for future expenses, had relevance only to the particular type of accrual accounting method that was there at issue, in which over-all estimates and averages of expenses were relied upon in determining reportable income.

This is evident from the *American Automobile* opinion itself. It referred to the effect of the legislative history of Sections 452 and 462 upon "the [accounting] practice as was used by the [Automobile] Association here" and upon "the method used by the Association." 367 U.S. at pp. 694-95. Elsewhere it discussed the action of Congress in enacting these sections as "specifically permitt[ing] essentially the same prac-

[7] See Brief for the Respondent in Opposition to Petition for Certiorari, pp. 9-10, Schlude v. Commissioner, No. 793, Supreme Court, October Term, 1961. See also Memorandum for the Respondent in Opposition to Petition for Certiorari, p. 5, Milwaukee & Suburban Transport Corp. v. Commissioner, No. 603, Supreme Court, October Term, 1961.

tice as was employed by the Association here"; the sections were described as the only ones "incontestably permitting," or that "specifically declared" to be acceptable, the method of accrual accounting used by the Association. *Ibid.* Finally, the opinion pointed to repeated unsuccessful attempts by the taxpayer in *American Automobile* to convince Congress to pass legislation which, in terms, would have authorized such membership clubs to use the very same type of accrual accounting system that was under review by the Court. *Id.* at p. 696.

Moreover, to read into this portion of the *American Automobile* opinion any broad rejection of accrual accounting for advance receipts, as respondent appears to urge, would disregard legislative and administrative developments that have occurred subsequent to the decision in that case:

a. On July 26, 1961, shortly after the *American Automobile* decision was handed down, there was enacted a new Section 456 in the 1954 Code (P.L. 87-109, 87th Cong., 1st Sess.) that allowed membership organizations such as the taxpayer in that case to report income as it is earned in performing the services for which their members pay dues. The congressional reports accompanying the enactment of this new section strongly suggest that in repealing Sections 452 and 462 in 1955, Congress did not intend to prohibit the use for tax purposes of all methods of accrual accounting for advance receipts or for reserves for future expenses without regard to how accurately and precisely any such method actually reflected income.

These congressional reports disclose that in taking the action it did in 1955, Congress was not concerned that the use of accrual accounting principles for tax

purposes would permit the reporting of advance receipts as income in tax years subsequent to the year of receipt. Rather, the reports state that in repealing Sections 452 and 462 Congress recognized "the desirability of following generally accepted accounting principles for reporting income for tax purposes," and that the two sections were being repealed only because "Congress became aware of the fact that a large revenue loss was involved" in the "first years of [their] application." H.R. Rep. No. 381, 87th Cong., 1st Sess., p. 2 (1961); S. Rep. No. 543, 87th Cong., 1st Sess., p. 2 (1961). Congress thus appears to have recently acknowledged that the use of proper accrual accounting methods for advance receipts and for reserves for future expenses was permissible for tax purposes before the enactment of Sections 452 and 462 and was not affected by their repeal in 1955.

b. The same conclusion is indicated by the recent issuance by the Commissioner of Internal Revenue of regulations under Section 455, enacted in 1958 to govern taxation of advance receipts for newspaper and periodical subscriptions. These regulations explicitly state that taxpayers who had previously been deferring to a subsequent tax year the recognition of such receipts as income "under an established accounting method" may continue to do so without regard to the specific provisions of Section 455 itself or of the new regulations thereunder.[9]

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[9] Regulations § 1.455-5(d) reads:

"Treatment of prepaid subscriptions income under an established accounting method. Notwithstanding the provisions of section 455 and § 1.455-1, any taxpayer who, for taxable years beginning before January 1, 1958, has reported prepaid subscription income for income tax purposes under an established

B. BOTH TAX ACCOUNTING LAW AND THE PRACTICAL CONSEQUENCES CALL FOR REJECTION OF ANY BROAD RULE PROHIBITING EVERY APPLICATION OF THE ACCRUAL ACCOUNTING METHOD THAT DEFERS REPORTING OF ADVANCE RECEIPTS AS INCOME TO A SUBSEQUENT TAX YEAR.

The foregoing analysis of the *American Automobile* decision makes clear that the case constitutes only a determination that rejection of the accrual accounting practices there involved was not an arbitrary decision by the Commissioner. It is also evident from this same analysis that there can be no warrant for joining the two portions of the majority opinion in *American Automobile*, as respondent would urge, to create a rule that prohibits every method of accrual accounting of advance receipts for tax purposes simply because it involves reporting such receipts as income in a subsequent tax year. Not only is any such rule unsupported by *American Automobile* but it is in direct conflict with fundamental principles governing accrual accounting for tax purposes that this Court has developed in an unbroken line of precedent since it decided the landmark case of *United States v. Anderson*, 269 U.S. 422.

1. *The Decisions of this Court.* The *Anderson* case interpreted the tax accounting provisions of the Revenue Act of 1916 (39 Stat. 771), the first tax statute to permit accrual accounting. The Court there required the taxpayer to accrue munitions taxes as a deduction in determining taxable income for a tax year prior to

and consistent method or practice of deferring such income may continue to report such income in accordance with such method or practice for all subsequent taxable years to which section 455 applies without making an election under section 455." T.D. 6591, February 23, 1962 (1962 Int. Rev. Bull. No. 12, at p. 17).

the year in which the taxpayer actually paid such munitions taxes. In ruling that the taxes had accrued in the year that the munitions to which the taxes related were sold (*id.* at p. 436), the Court declared that the purpose of Congress in authorizing the use of accrual accounting methods was (*id.* at p. 440)

> ". . . to enable taxpayers to keep their books and make their returns according to scientific accounting principles, *by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period*; and, indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis." (Emphasis added.)

Then, with specific reference to the accrual of the taxes involved in *Anderson*, the Court formulated the "all events" test that since then has served as the over-all standard for determining when an expense is incurred or income is to be reported by an accrual basis taxpayer (*id.* at p. 441):

> ". . . In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the [1916]

> statute . . . [was] concerned, the taxes had accrued . . ."[10]

The Court several years later applied the principles it had formulated in *Anderson* to other cases involving the time for accrual of the same munitions taxes and similar items of expense. *American National Co. v. United States*, 274 U.S. 99; *Niles Bement Pond Co. v. United States*, 261 U.S. 351; *Aluminum Castings Co. v. Routzahn*, 282 U.S. 92.

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[10] Significantly, the ruling and the language of the Court in *Anderson* echoed the position of the United States in that case. The Government's argument, which is quoted below, might well be included here without any change as the position of the Institute (269 U.S. at pp. 424-425):

> ". . . Under the accrual system of accounting, income is said to be accrued when it is definitely receivable, although its payment may not be due, and liabilities or expenses are said to be accrued when the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due. The basic idea under the accrual system of accounting is that the books shall immediately reflect obligations and expense definitely incurred and *income definitely earned* without regard to whether payment has been made or whether payment is due. Under this system, the use of the word 'accrued' does not signify that the item is due. On the contrary, the accrual system wholly disregards due dates. Neither is it necessary that the amount of an incurred liability be accurately ascertainable in order to 'accrue' it. Montgomery, Auditing Theory and Practice, 3rd Ed. Vol. 1, pp. 239, 240; Esquerre, Applied Theory of Accounts, pp. 299-301; Holmes, Federal Income Tax, 1917, pp. 299-301." (Emphasis added.) See Brief for the United States in United States v. Yale & Towne Mfg. Co., pp. 31-32, No. 420, Supreme Court, October Term, 1925 (companion case to *Anderson*).

In light of the Government's then position that accrual accounting methods are designed to reflect "income definitely earned," which the Government equated with "income . . . definitely receivable," it is difficult to understand its position now that advance receipts are "income" when they have not been "earned" or indeed—as in the *Schlude* case—neither earned *nor* received.

Two subsequent decisions, *Continental Tie & Lumber Co. v. United States*, 286 U.S. 290, and *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, treated the applicability of accrual accounting methods in determining when income is to be reported. It was recognized that accrual accounting might require the taxpayer to report income *before* he receives any payments as a result of the transaction that gives rise to the tax. In language that has often been quoted, the *Spring City* opinion (*id.* at pp. 184-185) declared that for the accrual basis taxpayer

> ". . . it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the *right* to receive an amount becomes fixed, the right accrues." (Emphasis in original.)

The Court chose this manner to restate a basic concept of accrual accounting: that income is to be reported as it is earned. Thus the opinion proceeded (*id.* at p. 185): "When a merchandising concern makes sales, its inventory is reduced and a claim [by it] for the purchase price arises." Such "sales," however, do not occur merely when a contract of sale is signed, but rather, as the Court made clear, when the taxpayer performs under the contract—or, in the accounting terms used by the Court, when there are "accounts receivable arising from the sales" (*ibid.*). Similarly, the *Continental Tie* case held, in somewhat different language, that the proper time for accruing income is determined when a taxpayer's "right to payment ripened" and when he had a "vested right" to payment—in that case upon the passage of legislation assuring that right and before the receipt of any payments by the taxpayer. 286 U.S. at pp. 294-295.

The foregoing decisions present no conflict with other cases in which the Court has declared that the tax statutes require all taxpayers—accrual as well as cash basis— to report "income" for an annual accounting period. It is entirely consistent with the reporting of *income* in an annual accounting period for an accrual basis taxpayer to postpone recognizing *advance receipts* as *income* until the tax year in which such receipts become income—as they are earned by the taxpayer's conduct of its business. This is the teaching of the cases dealing with the annual accounting requirement, such as *Security Flour Mills* v. *Commissioner,* 321 U.S. 281, *Lewyt Corp.* v. *Commissioner,* 349 U.S. 237, and *Consolidated Edison Co.* v. *United States,* 366 U.S. 380. They do not, we submit, support the erroneous proposition, which has been advanced by the Commissioner, that the annual accounting period concept requires an accrual basis taxpayer to report advance receipts as income no later than the year of actual receipt, regardless of whether earned by performance or not (and correlatively, that deductions must be taken no later than the year in which actually paid even though not yet incurred).[11]

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[11] See Brief for the United States, American Automobile Ass'n v. United States, pp. 19-20, No. 288, Supreme Court, October Term, 1960.

The Tax Court apparently embraced this position in the *Schlude* case (R. 258):

> "Nor does the fact that the Studio was required to perform future services under the contract alter the Studio's right to receive since the deferred payments were in many cases due [from students] prior to the rendering of the services. And the record shows that in most instances substantial payments were received prior to the performance of the services for which the payments were made."

In the *Security Mills* case the Court refused to permit a taxpayer to deduct from gross income in a tax year an item of cost (a flour processing tax) the liability for which the taxpayer denied and payment of which he was contesting in that year. The Court concluded that in these circumstances the tax had not yet been "accrued" as an expense. It therefore required the taxpayer to report as income the amount of the processing tax, which the taxpayer had passed on to its customers, in the year in which it sold the flour subject to the tax. With this background the Court's statement of the annual accounting principle as it applies to accrual basis taxpayers may be properly understood as only a restatement of the rule set forth in the *Anderson* and *Spring City* cases. For such taxpayers, the Court declared, the annual accounting principle requires income or expense to be allocated to "the year in which the right to receive, or the obligation to pay, has become final and definite in amount." 321 U.S. at pp. 286-287. The *Security Mills case*, therefore, like *Spring City*, is a recognition that the controlling issue in the reporting of income by accrual basis taxpayers is not the year of receipt but the year in which "the right to receive" becomes fixed. And a necessary corollary of any such rule is that the "right" arises—whatever the tax year—only when the taxpayer earns the income, regardless of whether it has received payments from, or is yet to be paid by, its customers.[12]

[12] Brown v. Helvering, 291 U.S. 193, which prohibited an accrual basis taxpayer from deferring the reporting as income commissions received on insurance policies that ran for more than one tax year, is not to the contrary. Although the taxpayer there had contended that the commission was "compensation for services rendered throughout the life of the policy" and that such compensation "cannot be considered as earned until the required services have been performed," the Board of Tax Appeals had found that

See also *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516, 518-519.

Lewyt Corp v. *Commissioner, supra*, and the more recent *Consolidated Edison* case confirm this analysis. In the former neither the majority nor the dissenting members of the Court, although disagreeing over what tax year another item of expense (again a tax—on excess profits) had "accrued," questioned that the basic issue was: in what tax year had the *obligation to pay* the amount deducted "accrued"? The opinions of the Court contain nothing that even remotely supports the Commissioner's current view that deductions "accrue," and therefore must be taken, no later than the year of payment.

This issue was finally and squarely presented and resolved against the Commissioner in *Consolidated Edison*. The Court unanimously held that an accrual basis taxpayer's deduction, again for a contested tax, is properly taken in the tax year in which a final determination of liability for the tax is made even though the tax had been paid in a prior year. In rejecting the artificial qualification the Commissioner sought to impose upon traditional principles of accrual accounting, the Court made the flat statement that "neither the Government nor an accrual-basis taxpayer may cause an item to be deducted in a year other-

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there was "no proof that the overriding commissions contain any element of compensation for services to be rendered in future years." *Id.* at pp. 203-204; 22 B.T.A. 678, 684-685 (1931). The taxpayer thus had failed to establish that the full commissions were not in fact "earned" when they were received in the tax year the policy premiums were paid. As Bressner Radio, Inc. v. Commissioner, 267 F.2d 520, 526 (2d Cir. 1959), points out, this Court's decision "was thus not a departure from but rather an insistence upon sound accrual accounting for earned income."

than the one in which it accrued." 366 U.S. at p. 385.[1] This recent statement, although made in a case involving the timing of deductions by an accrual basis taxpayer, is equally applicable in determining the tax year in which such taxpayers are to report advance receipts as income.

It is thus evident that a single rule only may be distilled from the Court's decisions that have dealt with the persistent question of when accrual basis taxpayers are to recognize receipts as income and when they are to deduct expenses from income. The Court has repeatedly determined: 1) as to the reporting of income, "all events" must have occurred that fix [illegible] taxpayer's right to funds that may previously have been paid to him or may still be due; and 2) as to taking deductions, "all events" must have occurred that fix the taxpayer's obligation with regard to expense that may previously have been paid by him or that he may yet be required to pay. The prior decisions thus supply no justification for selecting any other year for taxing amounts received than the year in which such amounts—whether received or to be received—are earned as income by the accrual basis taxpayer's performance. No other conclusion is warranted. Accordingly, any policy of the Commissioner that rejects a method of accrual accounting solely because it postpones the reporting as income of amounts received to

[1] The Government's attempt to distinguish the *Anderson, Dixie Pine* and *Security Mills* cases on the ground that in *Consolidated Edison* the taxes had actually been paid by the taxpayer in prior tax years was rejected. The Court, moreover, specifically disapproved of Chestnut Securities Co. v. United States, 104 Ct.Cl. 489 (1945), and Consolidated Edison Co. v. United States, 133 Ct.Cl. 376 (1955), in which the fact of payment of the tax in a prior year had been deemed crucial in determining when the deductible expense had accrued.

tax years subsequent to the year of receipt is without foundation.

2. *The Tax Statutes and Treasury Regulations.* The rule that the decisions of this Court stand for is in full accord with the relevant tax statutes and Treasury Regulations governing accounting for income tax purposes. The statutes and regulations supply plentiful authority for the use by accrual basis taxpayers of accrual accounting methods that precisely and accurately match revenues from services performed in the tax year with related costs of performance, notwithstanding that there may have been advance collection of the revenues. Significantly, these provisions explicitly acknowledge that accrual accounting methods may correctly result in postponing the reporting of advance receipts as income to such taxpayers to a tax year subsequent to that in which they receive such amounts for services to be performed or goods to be delivered thereafter.

It is axiomatic that the Commissioner of Internal Revenue is authorized to recompute a taxpayer's taxable income, as he did in *American Automobile* and in *Schlude*, only if the taxpayer has no regular accounting method "*or if the method of accounting used does not clearly reflect income*" (emphasis added). Otherwise, "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Int. Rev. Code of 1954, §§ 446(a) and (b); Int. Rev. Code of 1939, § 41. Section 451 (a) of the 1954 Code (1939 Code, Section 42(a)), moreover, specifically provides that the taxpayer's accounting method of computing taxable income may be one in which amounts of gross income—or receipts—are accounted for in tax

years other than the year in which such amounts are received:

> "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, *unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.*" (Emphasis added.)[14]

The Treasury Regulations interpreting Sections 446, 451 and their predecessor 1939 Code sections reflect the Commissioner's own recognition of the limits the tax laws place upon his power to recompute a taxpayer's taxable income. Treasury Regulation 1.446-1(a)(2) states that "a method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income." With regard to the accrual method of accounting, the Regulation incorporates the long established "all events" test for determining the tax year in which an accrual basis taxpayer is to report as income payments that have been or are to be received, or to take deductions for expenses paid or to be paid, in any other tax year.[15] (See discussion, pp. 19-25

[14] It should be emphasized that neither the *American Automobile* majority opinion nor the dissent referred to Section 451 and its language which expressly permits items of receipt to be reported as income in a year that is different from the year of receipt.

[15] Treas. Reg. § 1.446-1(c)(1)(ii) reads in part:

"*Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction

above.) And Treasury Regulation, § 1.451-1(a), specifically acknowledges that Section 451 of the 1954 Code authorizes an accrual basis taxpayer to report income in a tax year other than the tax year in which the taxpayer receives payment:

"General rule for taxable year of inclusion—(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. *Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the serv-*

and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. *For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books.* . . ." (Emphasis added.)

The "manufacturing business" cited as an example of an accrual basis taxpayer might receive advance payments from customers for products that will be delivered, or title to which will pass to the customers, in a subsequent tax year. The regulation authorizes such advance receipts to be reported as income at that later time. See *Woodlawn Park Cemetery Co.*, 16 T.C. 1067 (1951), *acq.*, 1951-2 Cum. Bull. 4 (prepayment for cemetery crypts); *Veenstra & De Haan Coal Co.*, 11 T.C. 964 (1948), *acq.* 1949-1 Cum. Bull. 4 (prepayment for coal).

ices are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. . . ." (Emphasis added.)[16]

The Treasury Regulations under the 1939 Code similarly recognized that amounts received by an accrual basis taxpayer may be properly accounted for and reported as income in a different tax year than the year of receipt (Treas. Reg. 118, § 39.41-2(a)):

"*Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.*

[16] Section 461 and Regulation, § 1.461 are the comparable provisions governing the proper tax year in which deductions are to be taken. Section 461(a) reads:

"General Rule. The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."

Regulation, § 1.461-1(a)(2) reads in part:

"*Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. . . . While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. . . ."

A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. . . . All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, *unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. . . .*" (Emphasis added.)

See to the same effect, Treas. Reg. 118, § 39.42-1(a).

Both the statutes and the regulations thus are entirely lacking in any support for the position that an accrual basis taxpayer who receives amounts in advance from customers that obligate him to perform services in subsequent tax years must report all such amounts as income in the year of receipt. Section 451 is explicit to the contrary, and nothing in Section 446 requires such a result. And the Treasury Regulations refer to situations in which the reporting of income may be postponed to a tax year subsequent to that in which the taxpayer receives such advances. Uniformly requiring the reporting of advance receipts as income in the year of receipt would thus disregard the plain import of the applicable statutes and regulations and would effectively deny the use of accrual accounting for such items. The Institute sees no reasons why, in the face of the long history of the recognition of accrual accounting in the federal tax laws,[17] this result should be desired by the Commissioner or accepted by this Court.

3. *The Practical Consequences.* The substantial adverse consequences that would result from requiring

[17] See American Automobile Association v. United States, 367 U.S. 687, 711-712 (dissenting opinion).

accrual basis taxpayers to report income no later than the year of its advance collection supply additional reasons for rejecting any such rule.

a. In the judgment of the Institute unnecessary differences between established principles of commercial accounting and accounting for tax purposes should be eliminated wherever possible. This objective has been frequently voiced by the Institute[17] and has been urged by others, including Government officials having responsibility for tax policy.[18] The area of accounting for advance receipts is one in which the Institute believes there is no persuasive reason for according judicial sanction to the distinctions between commercial accounting principles and tax accounting law that the Commissioner of Internal Revenue has been advocating.

As we have shown above, no considerations that flow from the tax laws and regulations themselves, or from the decisions of this Court, require rejection in this area of the applicability of commercial accounting principles to accrual accounting for tax purposes. To do so, therefore, will produce an unwarranted distinction between commercial accounting and tax accounting. Any such distinction, the Institute respectfully urges, not only lacks a statutory or decisional law basis but does positive harm by requiring accrual taxpayers to account for the same transaction differently for com-

[17] *E.g.*, J. Accountancy, pp. 710 et seq. (Dec. 1953); [illegible] pp. 294-295 (Sept. 1953).

[18] *E.g.*, 1954 Budget Message of the President, reprinted as H. Doc. No. 264, 83d Cong., 2d Sess. (1954); S. Rep. No. [illegible], 84th Cong., 1st Sess., p. [illegible] (1955) (repeal of Sections 452 and 462); H.R. Rep. No. [illegible], 84th Cong., 1st Sess. [illegible] (1955) (Ibid., [illegible] of Section [illegible]); S. Rep. No. [illegible], 84th Cong., 1st Sess. [illegible] (same).

mercial purposes than for tax purposes. Surely this result need not be encouraged when it is not required by law and furthers no sought for objective of policy.

b. Acceptance of the rule of accrual accounting for advance receipts advocated by the Commissioner would seriously distort the reporting of "income" by accrual basis taxpayers in the numerous industries in which customers ordinarily make advance payments against the taxpayer's performance of future services.[20]

It is fundamental that an advance payment from a customer is no different from—and is in fact—a financing transaction entered into by the taxpayer; in a practical sense the services that the taxpayer obligates him-

[20] A sampling of businesses on the accrual basis in which this practice is common, of which the Institute is aware, includes the following: Correspondence schools; technical instruction courses such as radio and television repair instruction; investment counseling services; gymnasium facilities; subscriptions to book of car wash certificates; purchase of tax or other legal research services with commitment to keep material therein up-to-date over specified period; purchase of tickets for theatrical, dramatic or musical performances series; purchase involving series of dinners with accompanying entertainment at selected restaurants; bookkeeping work to be performed over 3-year period; service of typewriters and other office equipment; purchase of encyclopedia with commitment to furnish supplementary volumes over next 5 or 10 years; purchase of toll road tickets; purchase of series of beauty treatments; purchase involving TV servicing and repair; purchase of flying lessons or driving lessons; purchase of instruction in foreign languages; contracts for taking of family photographs at half year intervals; contracts to develop film negatives and provide film; premiums paid for health and medical treatment and facilities; contracts to provide telephone answering services; contracts for construction and sale of project homes; contracts to erect prefabricated houses; contracts for building upkeep and maintenance, *e.g.*, window washing services; contracts for exterminators' services and pest control; manufacturers' service contracts, *e.g.*, service contracts on tabulators and computers or on canning equipment.

self to perform constitute repayment of the customer's "loan." At the time such advance payments are made, therefore, and before the taxpayer performs any required services, the payments "are liabilities and should be shown as such."[21] When a taxpayer receives such advances, he has no income. He has at most only an amount that is yet to be offset by his costs of performing services (or producing goods, as the case may be) in part in a subsequent tax year, at which time such part would be included in "gross income." To treat as taxable income funds that the taxpayer has "raised" in advance from his customers will produce a distortion of taxable income.[22] Conversely, taxable

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[21] Accountants' Handbook, § 20, p. 8 (4th ed. 1956), states:

"DEFERRED REVENUES. Advances by customers or clients which are to be satisfied by the future delivery of goods or performance of service are liabilities and should be shown as such. These items have often been labeled 'deferred revenues' or 'deferred credits,' and occasionally are classified on the equities side of the balance sheet between liabilities and proprietorship. Such titles are inclined to be misleading, and such classification is unwarranted. The essential peculiarity of such accounts lies in the fact that they are payable in goods or services rather than in cash, and that as a rule a margin of profit will emerge in making such payment. Under no circumstances should these items be offset against outstanding receivables, nor should they be recorded as earned income prior to delivery of goods or rendering the service for which advance payment has been received."

[22] Paton, W. A., "'*Deferred Income*'—A *Misnomer*," J. Accountancy, p. 39 (Sept. 1961):

"If there is a major point upon which there is general agreement in accounting it is that revenue results from the over-all process of production, and not from borrowing or otherwise raising funds. Moreover, for most lines of business, revenue is regarded as recognizable when product is delivered to the customer. It is also axiomatic that net income, if any, is the amount by which total revenue for the period, repre-

income will also be distorted by the improper allocation of costs—that is, by allocation of costs that the taxpayer must necessarily incur in the year of performance to receipts of any tax year other than that year.

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sented by the sale value of the delivered product, exceeds all the expenses, losses, and taxes properly applicable to such total revenue. In the face of these basic considerations how can we justify using the word 'income,' even with the qualifying term 'deferred' attached, to describe the amount of a customer advance? Such an advance may be received before the process of production has even been started, before any costs have been incurred, and before anyone knows for certain that any 'income' will ever be realized on the particular operation or contract!"

[23] These distortions of income created by any rule of tax accounting that requires the reporting of receipts as income no later than the year of receipt may be simply illustrated. In the first year that a taxpayer receives advance payments for performance over subsequent tax years, such a rule would show his income to be unrealistically high, since in that year he would not be permitted to deduct costs of performance in subsequent tax years from the advance payments. Of course, new advance payments received in subsequent tax years will be in part offset, and thus not reported as taxable income, by the deduction of performance costs incurred in those years that are attributable to advance payments reported as income in prior tax years. However, the taxpayer's income will continue to be distorted, since performance cost deductions of each year will not be matched with the advance payment items of prior years that necessitated those costs. Thus, in any tax year, if low performance costs that may be all that is required under prior years' contracts are deducted from relatively high advance payments of the current year, reportable income for the current year will be inflated. Admittedly income in any year might be *deflated* if the converse occurred, *i.e.*, relatively high performance costs attributable to earlier contracts are offset against low advance payments on the current year's contracts. But such inflation *or* deflation will occur purely by chance and will bear no rational connection to the earning of income by the taxpayer. Finally, if the taxpayer terminates his business, with the result that he receives no new advance payments but is required to incur performance costs under contracts entered into in prior tax years, he will report apparent losses in the amount of such performance costs, even though such contracts may in reality reflect profitable transactions.

See *American Automobile Ass'n v. United States*, 367 U.S. 687, 714 (dissenting opinion); Bierman & Helstein, *Accounting for Prepaid Income and Estimated Expenses Under the Internal Revenue Code of 1954*, 10 Tax L. Rev. 83, 88-89 (1954); Note, *Taxation of Prepaid Income: A Temporary Solution*, 67 Yale L.J. 1425, 1428-1429 (1958).

It is evident that if year-to-year distortion of the taxable income of accrual basis taxpayers having advance receipts is to be avoided, a precise and accurate matching of revenues from services performed in each tax year with related costs of performance should be achieved. Whenever this is possible, any tax accounting rule that requires income to be reported no later than the year of receipt can not be justified.[24]

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[24] The Institute acknowledges that accrual basis taxpayers are required to report advance collections on certain types of commercial transactions as income in the year of receipt. This rule is perhaps most clear in the case of advance collections under a lease. See, e.g., Hort v. Commissioner, 313 U.S. 28, 30 (dictum); Hyde Park Realty Co. v. Commissioner, 211 F.2d 462 (2d Cir. 1954); Treas. Reg. § 1.61-8(a). Although the Institute takes issue with this rule from an accounting standpoint, the taxation of such advance receipts in this manner may be explainable by the fact that the major right which the lessor of premises or other property grants to the lessee at the time he enters into a lease is the right to occupy or use the property, and typically there is little else by way of further performance required of him in subsequent years. In any event, however, that such an established rule exists in this and other areas of tax law does not justify its extension, and thereby the perpetuation of a further unwarranted distinction between commercial accounting principles and tax accounting, to the situation of taxpayers whose advance collections are related to their performance of services that very largely are to be rendered in subsequent tax years.

II. The Method of Accrual Accounting for Advance Receipts Used by the Taxpayers in *Schlude* Accurately and Precisely Matched Revenues from Services Performed in Each Tax Year With Related Costs of Performance.

The question remains whether the accrual accounting method used by the *Schlude* taxpayers precisely and accurately matched revenues derived from services performed in each tax year with the cost of performing such services, and thus reflected "true income." The Institute believes that the accounting method achieved this result and that for this reason the decisions of the Court of Appeals below and of the Tax Court were erroneous.

1. There can be no serious dispute over whether the accrual accounting method used by the *Schlude* taxpayers was such as to satisfy even the stringent standards set forth in *American Automobile* with regard to the matching of receipts with the cost of performance. The *Schlude* taxpayers operated a type of business which—like many others—enabled them to account accurately for receipts from, and costs of, individual business transactions. Under the accounting method used there was recorded on a card for each student who had entered into an instruction contract with the partnership the number of hours of instruction provided to him under his contract in each tax year. The gross income from each contract was determined for each tax year by multiplying the hours of instruction given by the hourly rate applicable to that contract. There were then offset against that year's gross income from all contracts the various costs incurred during the year (R. 185-188).

This accounting method accomplished an appropriate matching of receipts and costs since the partnership's costs were incurred in the period and to the extent that it rendered services under each contract (R. 193-194, 218-219, 252). Typical items of cost incurred by the partnership, such as rent and utilities, were of course readily determinable and, as expense items applicable to all the service contracts, required no allocation among individual contracts. The single major item of cost that varied from contract to contract, depending upon when instruction was given, was the payment of salary to instructors. This cost was precisely allocable to each contract, since instructors were paid by the number of lessons taught (R. 194-195). Taxable income of the partnership was thus reported in each tax year precisely to the extent it was earned in fulfilling the partnership's contract with each student that year, as reflected in the partnership's records (R. 185-188, 251-257).

2. The accounting procedures used in *Schlude* leave open only one objection of those that were urged upon the Court to sustain the Commissioner's rejection of the taxpayer's accrual accounting method in *American Automobile*. That relates to the claim that, in *Schlude* as in *American Automobile*, the contracts did not definitely schedule the performance of services by the taxpayers in tax years subsequent to the year a contract was entered into.[25]

Admittedly, *American Automobile* quoted approvingly from the prior *Automobile Club of Michigan* decision in which the Court deemed it to be a factor that,

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[25] However, while no schedule was set forth in the contract, as each lesson was given the next lesson was scheduled (R. 227).

services in subsequent tax years were performed by the taxpayer "only upon a member's demand" and that "the taxpayer's performance was not related to fixed dates after the tax year." 353 U.S. at p. 189, n. 20; 367 U.S. at p. 691. The substance of the opinion in the more recent decision, however, makes it apparent that the Court's chief concern was not with this aspect of the taxpayer's business dealings with its members. Rather, as we have previously urged (pp. 12-13 above), *American Automobile* emphasized the Association's inability to point precisely to its cost of performing services for individual members in contrast to its over-all costs for all service contracts "on a group or pool basis." *Id.* at p. 693.

Analysis of what is sought to be achieved by a precise and accurate method of accrual accounting for advance receipts reinforces this reading of *American Automobile*. The key aim of accrual accounting for tax purposes, as the Court has often recognized (see cases discussed at pp. 19-25 above), is to determine the proper reporting of taxable income by matching appropriate costs against related revenues of the tax period. If a taxpayer's accounting method is suitable to this task, and if it satisfies the requirement of *American Automobile* for a precise matching of costs and revenues of the tax year that are allocable to individual customers or transactions, there is no reason to attach significance to the fact that the taxpayer will perform in subsequent tax years, and thus incur costs and earn income, only upon the demand of his customers.

This is not to say that a taxpayer who had made advance collections would be authorized to postpone indefinitely the reporting of such amounts as income if it developed that no such customer demand

for performance were made. A common sense application of accrual accounting principles would of course require that after a *period certain* the taxpayer report as income any advance receipts that had not by that time been earned by performance. For this reason, although a taxpayer's ultimate performance under a long-term contract might be uncertain and contingent, its reporting of all advance receipts as income in some year or years would not be.

This was the case in both *American Automobile* and *Schlude*. In the former the taxpayer necessarily reported all advance receipts as income no later than the end of the period for which its service contracts were in force. 367 U.S. at pp. 688, 690. In *Schlude* each service contract required that all the instruction thereunder be taken in a time certain, and accordingly all income would have been reported by the end of that time (R. 146-149).[*] Moreover, all income might have been reported earlier, since the *Schlude* taxpayers' established accounting practice was to report as income the excess of all cash amounts received over income earned by performance on contracts where the contracts were cancelled by students or where no instruction had been given for one year (R. 192-193, 253). There could thus be no avoidance of taxable income by the taxpayers.

The Institute accordingly urges that the factor of uncertainty of performance alone should not be enough to authorize the Commissioner to reject an accrual accounting method—such as that of the *Schlude* taxpayers—that fully satisfies accepted accounting prin-

[*] Each contract included an explicit acknowledgment by the student "that this course of [number of] hours of dancing lessons expires on [specified date]" (*e.g.*, R. 146).

ciples in every respect and at the same time gives rise to no loss of revenues to the Government.

III. The Error of the Courts Below Is Highlighted by Their Ruling That the *Schlude* Taxpayers Must Report as Income in the Year of Execution Portions of the Face Amount of Long-Term Contracts That Have Been Neither Received Nor Earned.

Because of the manner in which the *Schlude* taxpayers' business was conducted, the decisions of the courts below involved an added element that in no sense could be said to fall within the *American Automobile* case and that, if not reversed by this Court, will have a far more severe impact upon accrual basis taxpayers than any decision affecting tax accounting for advance receipts alone.

The *Schlude* taxpayers carried on their business to a very large extent through executory service contracts under which a student made a down payment and promised to make future payments during the life of the contract, which frequently extended into subsequent tax years (R. 160-161, 184, 250). In addition to ruling that all advance payments actually received under any contract were to be reported as income in the tax year in which that contract was signed, the courts below further held that the taxpayers must report as income at the same time the face amount of the future contract payments to be made by students, even though such payments had been then neither earned nor received by the taxpayers. The decisions below thus required the reporting as income of the entire face amount of each contract in the tax year in which the contract was entered into.

This ruling, the Institute submits, highlights the erroneous understanding by the courts below of fundamental principles governing accrual accounting for tax purposes that should be corrected by this Court.

1. Wholly apart from any question of the adequacy under accounting principles of accounting methods used by accrual taxpayers such as those in *Schlude*, the *American Automobile* decision can not be read to authorize the Commissioner to require that the entire face amount of long-term service contracts be reported as income in the tax year in which the contract is signed. Nothing in *American Automobile* supports such a result. The taxpayer there always received in advance amounts paid by its members as dues and in return for which the taxpayer became obligated to perform services. In requiring the reporting of the advances as income when received, the Court was strongly influenced by the fact that such funds were immediately available to the taxpayer for its use.

In the *Schlude* case, not only were large amounts to be collected under the service contracts in subsequent years, but, the record discloses, there was no assurance whatsoever that such subsequent payments would in fact be made.[27] A great number—almost 20 percent—of the service contracts were cancelled or defaulted by the students; others of the contracts were required to

[27] In the tax years in question—1952, 1953 and 1954—the taxpayers had neither received from students nor earned by performance \$71,570.97, \$124,445.84 and \$119,710.38, respectively, on contracts entered into in each of the above years and in prior years (R. 145, Pet. Ex. 14-X). (The above figures are derived from Exhibit 14-X by subtracting for each year the "Deferred Income Collected-Ending Balance," considering the Reserve Fund held by the bank as not collected (see p. 3, n. 1 above), from "Contract Amount of Deferred Income-Ending Balance.")

be rewritten for a smaller number of lessons than had been contracted for initially, in order to persuade students not to cancel or default entirely on the contracts (R. 192, 239). And, the cancellations and defaults took place, and the rewriting of contracts for shorter periods was necessary, even though each contract contained a clause providing that it was noncancellable (R. 146-149, 193). In these circumstances, it is apparent that the taxpayers could by no means expect that they would receive the uncollected portion of a long-term contract signed by a student.

Far more significant, of course, from the standpoint of the Institute in opposing taxation of the uncollected amounts is the fact that when the service contracts were signed, those amounts were not at all earned by the taxpayers' performance. For this reason there was no warrant for taxing the future payments as income when the contracts were signed.

Commissioner v. Hansen, 360 U.S. 446, the only case cited to the Court of Appeals below by the Commissioner in support of taxing the entire face amounts of the service contracts, is wholly inapposite.[28] In *Hansen* the accrual basis taxpayers had fully performed their obligations under contracts with customers—by delivery of vehicles that had been sold—and had accordingly earned all of the contract price. See *id.* at p. 448. For this reason it was of no significance for accrual accounting purposes that a part of the contract price was being held in reserve accounts for the taxpayers by their financing organizations and would not be paid to them in cash until subsequent tax years. The amounts held in reserve had been as much earned by

[28] Supplemental Memorandum for the Respondent on Remand to the Court of Appeals for the Eighth Circuit in *Schlude v. Commissioner* (pp. 6-8).

those taxpayers as the amounts actually paid in cash to them as down payments by car buyers and the amounts paid by the financing organizations, to whom the taxpayers sold the negotiable notes of the car buyers for the balance of the contract price. The conclusion was thus compelled that the *Hansen* taxpayers had a "fixed right to receive" the amounts they were seeking to postpone reporting as income, and under fundamental principles governing accrual accounting for tax purposes (see pp. 19-25 above) this was sufficient to subject those amounts to tax.

In *Schlude*, on the other hand, substantial portions of the contract amounts remained not only uncollected when the contracts were signed, but also remained unearned by the taxpayers until they performed the services the contracts called for.[29] Simply stated, the

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[29] It would, of course, be equally improper to equate the situations of the taxpayers in the *Hansen* and *Schlude* cases merely because in both proceedings the taxpayers discounted with financing organizations all or part of long-term contracts on which amounts remained unpaid. See p. 3, n. 1 above. The fact that in both cases the financing organizations withheld a portion of the discounted value of the contract in a "reserve account" no more determines the tax year in which the *Schlude* taxpayers should have reported income than the fact that the bank actually paid them only 50 percent of the unpaid portion of the contract in cash immediately. The test in each instance should be: what portion of the cash payments and of the reserve accounts—like payments made by students to the taxpayers directly—was earned in any tax year.

The "services" rendered by the taxpayers in *Schlude*, moreover, were the essence of their business. They were thus unlike the incidental services (*e.g.*, account collection, repossession of goods, repurchase of contracts defaulted) to which taxpayers comparable to those in *Hansen* have pointed in unsuccessful attempts to urge that part of the purchase price of goods had not been earned at the time of sale. See General Gas Corp. v. Commissioner, 293 F.2d 35, 40-41 (5th Cir. 1961), *cert. denied*, 369 U.S. 816; Bruce Flournoy Motor Corp. v. United States, CCH Trade Reg. Rep. ¶ 9695, at page 85,820 (E.D. Va. July 16, 1962).

uncollected amounts—like the advance receipts—were amounts that the *Schlude* taxpayers would have a "fixed right to receive" only as they performed services.

Such a "fixed right," moreover, did not exist at the time the contracts were entered into merely because contract payments were ordinarily received prior to any performance by the taxpayers and at any point during the life of a particular contract such payments might or might not be greater in amount than the contract value of the services rendered by the taxpayers. A contract providing for payment prior to or unrelated in time to performance does not give the party obligated to perform in the future a fixed right either to retain prior payments or to receive future payments if he disables himself from performing or attempts to alter the performance required of him under the contract. 3A Corbin, *Contracts*, § 654 (1960 ed.); 3 Williston, *Contracts*, §§ 812, 830, 860 (1936 ed.); *Restatement, Contracts*, §§ 269-270; Patterson, E. W., *Constructive Conditions in Contracts*, 42 Colum. L. Rev. 903, 914, *et seq.* (1942). Under settled law, therefore, the *Schlude* taxpayers, as all other similar taxpayers who contract to perform services (or to produce goods) in subsequent tax years, were required to hold themselves in a position to perform in the manner that they had agreed as a condition to receiving and retaining payment.[30]

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[30] Respondent has disclaimed taking the position "that an accrual basis taxpayer must accrue income whenever he signs a contract to perform services." Urging what we believe to be an entirely outmoded argument of contract law concerning "dependent" and "independent" covenants, it has pointed to what it conceives of as the "seemingly unusual features" and the "atypical payment provisions" of the *Schlude* service contracts in an at-

Not only may no support be gleaned from the *Hansen* and *American Automobile* cases for the aspect of the decisions below dealing with the contract amounts that were both uncollected and unearned, but as a matter of simple justice it cannot be that such portions of the face amount of a service contract for a term of years may be taxed in their entirety as income in the year the contract is signed. Such a result is improper and arbitrary. It has no more justification than would the taxation at the face amount of all future interest coupons on a bond, or of all future rental under a lease, in the year in which the bond is purchased or the property leased. And it would compel accrual basis taxpayers to report as income amounts far in excess of what is demanded in comparable situations of cash basis taxpayers, who report in the tax year of receipt only the discounted fair market value of compensation paid to them in property other than cash.[31]

2. The improper extension of this Court's *American Automobile* decision by the Court of Appeals below to amounts not yet received would be remedied if this Court were to decide that the *Schlude* taxpayers' accrual accounting system is proper for tax purposes.

The taxpayers' accounting method in *Schlude* was as accurate in determining income in a tax year for

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tempt to justify taxing their entire face amounts in the tax year in which the contracts were signed. See Brief for the Respondent in Opposition, *Schlude v. Commissioner*, pp. 11-12, No. 793, Supreme Court, 1961 Term. Respondent thus appears to have agreed that if its understanding of the applicable law of contracts is erroneous, its position that the *Schlude* taxpayers had a "fixed right to receive" the face amounts of the contracts in the tax year of signing is likewise in error.

[31] See Treas. Reg. § 1.61-2(d); see also Note, 48 Va. L. Rev. 731, 745-749 (1962).

the uncollected portions of the service contracts as it was for the portions as to which the taxpayers received advance receipts. Under the accounting procedures that were followed, the taxpayers simply reported all income precisely as it was earned under each contract through their performance of services in each tax year, without regard to whether cash amounts allocable to the taxpayers' performance might or might not have been in fact paid by a student. It was thus possible that the taxpayers would have reported income under a contract as to which they had performed more services than they had actually been paid for in cash. As we have noted (p. 21 above), this result is of course proper under accrual accounting, and can not be objected to by accrual basis taxpayers, for the reason that income in such a case has been "earned"—that is, properly accrued—by the taxpayer. The *Schlude* taxpayers' objection, therefore, and the concern of the Institute, is not merely that uncollected contract amounts should not be taxed in the tax year the contract is signed because the taxpayers have received no cash as to such amounts, but more importantly, that the uncollected amounts should not be taxed until the tax year in which the taxpayers' performance of services earns income.

CONCLUSION

For the foregoing reasons, the Institute urges that the decision of the Court of Appeals for the Eighth Circuit be reversed.

Respectfully submitted,

DEAN ACHESON
FONTAINE C. BRADLEY
JOHN T. SAPIENZA
701 Union Trust Building
Washington 5, D.C.
Attorneys for Amicus Curiae American Institute of Certified Public Accountants

ROBERT L. RANDALL
ALVIN FRIEDMAN
COVINGTON & BURLING
Of Counsel

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